DOCUMENT RESUME

ED 299 662 EA 020 217

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TITLE School Finance under the Internal Revenue Code of 1986.
INSTITUTION Kraft and McManimon, Newark, NJ.
PUB DATE 87
NOTE 48p.; Presentation by Andrea Kahn of materials prepared by the law firm of Kraft and McManimon (formerly Kraft and Hughes) for the Annual Meeting of the Association of School Business Officials International (San Antonio, TX, October 18-22, 1987).
PUB TYPE Legal/Legislative/Regulatory Materials (090) -- Collected Works - General (020) -- Speeches/Conference Papers (150)

EDRS PRICE MF01/PC02 Plus Postage.
DESCRIPTORS *Economic Change; *Educational Finance; *Finance Reform; Interest (Finance); *Money Management
IDENTIFIERS *Tax Exempt Bonds; *Tax Reform Act 1986

ABSTRACT

One paper, one published article and one transcript of testimony that discuss school finance under the Internal Revenue Code of 1986 are presented. "Select Topics of the Tax Reform Act of 1986 for the Issuers of Tax-Exempt Governmental Obligations," by Carla J. Smith, presents three selected topics that address the issuers of tax-exempt governmental obligations. Included are the issue of rebate, which refers to payment to the federal government of all of the net earnings on investments; bank-qualified issues that have changed recently; and a new informational form required with all tax-exempt governmental debt in excess of $100,000. Next, an article reproduced from the publication "The Bottom Line," entitled "Congress and Courts Deprive States of Sovereign Power: The Power to Tax Is the Power to Destroy," by John L. Kraft and Felicia L. Garland, questions the apparent abandonment of sovereign state powers through federal judicial review of taxation based on municipal bond income for senior citizens who are receiving Social Security. Last, testimony by John L. Kraft on the "Tax Reform Act of 1986," delivered before the Economic Development and Agriculture Committee of the New Jersey State Assembly is presented. This testimony discusses federal legislation restricting the use of tax exempt bond financing by state and local governments and concludes by addressing the constitutionality of the federal government's power to tax interest on state and municipal bonds. (LMS)

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ED299662

# 1987 ASBO INTERNATIONAL CONFERENCE
# SAN ANTONIO, TEXAS

## SCHOOL FINANCE UNDER THE INTERNAL REVENUE CODE OF 1986

Presented by
Andrea L. Kahn of
Kraft & McManimon

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
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3. Testimony of John L. Kraft, Esq. on October 20, 1986 on the Tax Reform Act of 1986 before the Assembly Economic Development and Agriculture Committee and the Assembly Appropriations Subcommittee on Government Operations.



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June 11, 1987

## SELECT TOPICS OF THE TAX REFORM ACT OF 1986 FOR THE ISSUERS OF TAX-EXEMPT GOVERNMENTAL OBLIGATIONS

By: Carla J. Smith, Esq.

"Rebate" . . . "Bank-Qualified Issues" . . . "Form 8038-G Informational Returns" . . . . These and other terms have become a part of the vocabulary of tax-exempt bond issuers since the enactment of the Tax Reform Act of 1986 (the "Act"). The Act provided the most sweeping changes to the United States Tax Code in more than thirty years. Tax-exempt obligations have been significantly affected by the Act. This article details three provisions of the Act that governmental units must be familiar with prior to the issuance of tax-exempt debt.

## REBATE

"Rebate" refers to the payment to the federal government of all of the net earnings on investments of the "gross proceeds" of an issue of tax-exempt bonds or notes and all earnings on such earnings. With respect to governmental debt, this general rebate rule applies to bonds and notes issued after September 1, 1986.

"Net earnings on investments" means all income earned on the proceeds received from the issuance of debt obligations above the "yield" on such obligations (plus all income earned on such amounts).

"Yield" does not mean interest rate. Yield, as defined under the Act, is determined on the basis of the issue price (or yield) at which bonds or notes are offered to the public. This definition of yield requires an issuer to disregard the costs of issuing the obligations, including the underwriter's "spread" in the calculation. For example, if a municipality sells notes to a bank or underwriter at the rate of 5.00% per annum, the "yield" on the notes would be the initial reoffering price to the public which is less than 5.00%. Thus, if the bank or underwriter purchased the notes and in turn sold them to the public at a yield of 4.75%, then the yield on the notes determined under the Act would be

4.75%. Any investment of the note proceeds at a yield higher than 4.75% would create an excess to be rebated to the federal government.

Net investment earnings should not be confused with the accounting process of adding up the actual amount of earnings on investments and comparing that figure with the amount of interest paid on the obligations during that same period. For example, a municipality sells to its local bank $1,000,000 of bond anticipation notes on June 15, 1987, maturing June 15, 1988, and bearing the rate of 5.00% per annum. The bank reoffers the BANs to the public to yield 4.75%. The municipality immediately pays out $500,000 of the proceeds for outstanding bills. The remaining $500,000 is invested yielding 5.50% per annum until June 15, 1988. The rebate requirement would be calculated on June 15, 1988 as follows:

| | | | |
|---|---|---|---|
| (a) | Amount earned: $500,000 x 5.50% | = | $27,500 |
| (b) | Amount which would have been earned if proceeds were invested at the yield on the Bond Anticipation Notes: $500,000 x 4.75% | = | 23,750 |
| (c) | Amount to be rebated: (a) - (b) | = | $ 3,750 |

Note that the actual interest paid on the notes for the year of $50,000 ($1,000,000 x 5.00%) is greater than the actual earnings of $27,500. Nevertheless, a rebate obligation of $3,750 arises.

"Gross proceeds" of an issue are defined in the Act to include original proceeds received from the sale of obligations, earnings on those proceeds, any amounts to be used to pay debt service on the obligations and any other amounts that the Secretary of the United States Treasury Department determines in regulations to be included as gross proceeds. The term will be interpreted broadly by the Treasury Department to include transferred proceeds (the amount of prior issues left unspent at the time of renewal or refunding of such prior issues), reserve funds and securities or other obligations pledged as security for the payment of debt service on the obligations. This means that keeping track of net earnings on investments will not be limited to the amount of bonds or notes issued, but may include other funds. It is anticipated that the regulations will be available by the end of the summer of 1987.

## Exceptions to Rebate

There are generally three exceptions to the rebate rule available to issuers of governmental bonds and notes.

I. Six Month Expenditure Exception

If an issuer expends 100% of the gross proceeds of an issue for the governmental purpose for which they were issued within six months of the date of issue, no rebate of any income earned during the six month period need be rebated. (Gross proceeds which are held in a bona fide debt service fund are not considered gross proceeds for application of this six-month rule; see below.)

However, for issuers with general taxing power, if the amount of proceeds not expended at the end of six months does not exceed the lesser of 5% of the proceeds of the issue or $100,000, then an additional six months to spend all of the proceeds is allowed.[1]

Actual expenditure of the proceeds is required. Incurring a contractual obligation to expend will not qualify for the exception. Prepayment of contracts that are not traditional prepayments will not count as expenditure of the proceeds. In addition, paying off bonds or notes with the proceeds of the issue prior to the expiration of the six month period is not an expenditure.

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[1] This extra six month period does not apply to tax anticipation notes or other revenue anticipation notes.

Only one six month period is allowed and it is measured from the date of the first issue of obligations. Thus, if a county issues a six month BAN and renews it at the end of the six months, a new six month period is not allowed for the moneys remaining unspent. Whether or not all of the proceeds of the issue are expended in six months is measured from the date of first issue of the obligations.

**Application of Six-Month Exception to Tax and Other Revenue Anticipation Notes**

In the case of tax anticipation notes or other revenue anticipation notes (hereinafter "TANs"), a safe harbor for determining when the TAN proceeds have been spent for purposes of the six-month exception is set forth in the Act. If the amount of the actual "cumulative cash flow deficit" (the expenditures less amounts available and the revenues received during the period of calculation[2]) exceeds 90% of the face amount of the issue for the period of calculation, then the proceeds of the issue will be deemed to have been expended for purposes of meeting the six-month expenditure exception to the rebate rule.

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[2] The period of calculation is the period ending on the earliest of (i) the maturity of issue, (ii) six months from the date of the issue or (iii) the date of the computation of the cumulative cash flow deficit.

For example, County A plans to issue 1 year TANs on July 1, 1987 in anticipation of tax revenues. The cash flow chart of expenditures and revenues prepared by the County is set forth as follows:

| | Expenditures | Revenues | Monthly Surplus (Deficit) | Cumulative Surplus (Deficit) |
|---|---|---|---|---|
| Beginning Balance | - - | - - | - - | $2,000,000 |
| July, 1987 | $2,500,000 | $1,000,000 | ($1,500,000) | 500,000 |
| August, 1987 | 3,000,000 | 1,500,000 | (1,500,000) | (1,000,000) |
| September, 1987 | 3,000,000 | 2,000,000 | (1,000,000) | (2,000,000) |
| October, 1987 | 3,000,000 | 4,000,000 | 1,000,000 | (1,000,000) |
| November, 1987 | 3,200,000 | 2,000,000 | (1,200,000) | (2,200,000) |
| December, 1987 | 3,200,000 | 8,000,000 | 4,800,000 | 2,600,000 |
| January, 1988 | 3,200,000 | 1,000,000 | (2,200,000) | 400,000 |
| February, 1988 | 3,200,000 | 4,000,000 | 800,000 | 1,200,000 |
| March, 1988 | 3,200,000 | 3,000,000 | (200,000) | 1,000,000 |
| April, 1988 | 3,000,000 | 1,500,000 | (1,500,000) | (500,000) |
| May, 1988 | 3,000,000 | 4,000,000 | 1,000,000 | 500,000 |
| June, 1988 | 3,000,000 | 4,000,000 | 1,000,000 | 1,500,000 |

The maximum amount of TANs that could be issued without subjecting the issue to rebate would be approximately $2,444,000. This is determined by adding the total revenues and other funds available through November ($12,500,000) subtracting the expenditures through November ($14,700,000) to obtain the actual cumulative cash flow deficit for the period of calculation ($2,200,000). $2,200,000 represents 90% of the amount that may be borrowed. One hundred percent would be $2,444,444. ($2,200,000 x 100/90). Note that the current regulations would allow a maximum amount of $5,400,000 TANs to be issued (the maximum cumulative cash flow deficit of the $2,200,000 November deficit plus the next month's expenditures

of $3,200,000). However, if the maximum amount is borrowed, rebate cannot be avoided. Again, the actual deficit must be realized during the calculation period.

Controversy has arisen over what constitutes amounts available during the period of calculation. The General Explanation of the The Tax Reform Act of 1986 prepared by the Staff of the Joint Committee of Taxation and published on May 4, 1987 contained a reference in footnote 173 of the Tax-Exempt Bond Provisions Section which provided:

> In determining whether an amount is available to a governmental unit, . . . rules [to be adopted by the Treasury Department] may provide that the fact that the amount is deposited in special purpose accounts or otherwise earmarked is to be disregarded if the governmental unit using the TAN proceeds either (i) established the restrictions on the use of the other funds, or (ii) has the power to alter the use of the other fund.

This footnote could possibly be interpreted as having to include self-insurance funds and other funds of that type in calculation of the cash flow deficit. On June 2, 1987, the Treasury Department issued a statement which effectively postponed the implementation of this controversial footnote 173 until such time as regulations are issued.

II. **Small Issuer Exception**

If a governmental unit with general taxing power does not to issue more than $5,000,000 of tax-exempt obligations (excluding private activity bonds, as defined in the Act) in a

calendar year, then there will be no rebate requirement if at least 95% of the proceeds are to be used for local governmental activities. In determining whether the $5,000,000 small issuer exception applies, all bonds or notes issued by "subordinate entities" must be counted. The Conference Report accompanying the Act explains "subordinate entities" as including entities deriving their issuing authority from another entity or subject to substantial control by another entity.

> For example, a sewer or solid waste authority created by a city or county in order to issue bonds for that city or county is considered a subordinate entity. An entity is not to be considered subordinate solely because of geographic inclusion in a large entity (e.g., a city located within a larger county), if the smaller entity derives its powers independently of a larger entity and is not subject to significant control by the larger entity.

Thus, any authority which issues tax-exempt bonds within a county or municipality would have to be counted in adding up to the $5,000,000. See the discussion of subordinate entities under the topic heading "Bank-Qualified Issues."

III. **Bona Fide Debt Service Exception**

Amounts earned on a bona fide debt service fund do not have to be rebated if the gross earnings on such fund for the bond year are less than $100,000. A bona fide debt service

fund is merely a holding place to accumulate revenues to pay principal and interest on bonds and notes. It must be depleted at least once a year except for a reasonable carry-over amount (the greater of one year's earnings on the fund or one-twelfth of annual debt service). This exception was created to obviate the need to keep track of relatively small sums of earnings.

Keeping Track of Investments

An accounting system must be utilized that will track investments and expenditures of note and bond proceeds (regardless of whether the proceeds are commingled with other accounts) so that the yield on the investments can be determined and the rebate calculations made. On the investment side, the date of investment, the purchase price, the maturity and the interest rate on the obligation must be recorded. The Act requires that the "market price rules" be followed for the investment of all proceeds. In other words, a governmental unit may not simply invest proceeds of an issue at a yield lower than the yield on the issue to avoid the rebate if the "market" for that investment is higher. For example, if six month certificates of deposit ("CD") rates are yielding 6.00% per annum, an issuer may not "arrange" with a bank to invest in a six month CD yielding 5.00% per annum because that is the yield on the issuer's notes. The 6.00% rate will be attributed to the investment and a rebate will be required even if not received.

The market price of a commercial bank CD is the bona fide bid price quoted by a dealer who maintains an active secondary market in such CDs. If there is no active secondary market, the market price will have been established if the yield on the CD is (A) as high or higher than the yield on comparable obligations traded on an active secondary market as certified by a dealer who maintains such a market or (B) as high or higher than the yield available on comparable obligations offered by the United States Treasury. If a dealer certificate cannot be obtained, it is prudent for an issuer to receive three bids for a CD investment and accept the highest yield, following the regulations regarding investment contracts described below.

The general practice for determining the market price of an investment contract is to receive at least three bids on the investment contract from persons other than those with an interest in the issue (e.g., the underwriter or purchaser) and to invest in a contract yielding at least equal to the yield offered by the highest bid received. A copy of the market price rules taken from the arbitrage regulations is attached as Exhibit A to this article.

Careful record keeping will be the key in tracking investment yield and assuring compliance with the market price rules. A separate "Rebate Account" should be established for of bonds or notes. All investment earnings on gross proceeds

above the yield on the bonds or notes should be deposited into the Account and all earnings on the Account should remain therein until rebated.

Investments Not Subject To Rebate

Investment of gross proceeds of bonds and notes in certain types of obligations are not subject to the rebate requirement. These are (1) other tax-exempt obligations and (2) U.S. Treasury Obligations-State and Local Government Securities ("SLGs"). Tax-exempt obligations include tax-exempt mutual funds or bond funds. The types of tax-exempt obligations that governmental units may invest in are defined by State law. In addition, the maturities and the interest rates available may not be suited to the needs of the investing governmental unit. SLGs are available from the federal government for the purpose of avoiding the necessity to calculate rebate on investments. These SLGs are called Demand SLGs and are available upon 3 days written notice to the Federal Reserve Bank. The investments may be accessed on 1 day notice for the purpose the bonds or notes were issued for. SLG Regulations require that all of the proceeds subject to rebate must be invested in SLGs or in tax-exempt obligations in order to invest in the SLGs at all. In addition, the yields on Demand SLGs (determined for the week on Mondays) has been very low (i.e., 3.99% for the week beginning June 8, 1987). Demand

SLGs have been available since February 1, 1987. However, because of the restrictions on other investments and the low yields, few governmental units choose this option of avoiding rebate. It should be noted that the Treasury Department is contemplating using a different formula for the calculation of Demand SLG yields and easing the restrictions of investing in order to make the SLGs a more attractive investment.

**Procedures for Rebate**

The Act requires that at least 90% of the rebatable amount be paid once every five years and within 60 days of the final redemption of the issue. In the case of notes, this will mean more frequent rebate payments because the final redemption is the date the notes mature.

It is expected that the regulations setting forth the timing of the rebate calculations will require the rebate calculation must be made at least once a year.

For bond issues, where the rebate may be paid every five years, positive arbitrage in one year may be offset by negative arbitrage in another year. However, once a rebate is paid, no refunds will be paid by the federal government for any negative arbitrage after the payment date.

The penalty for failure to comply with the new rebate provisions is generally retroactive taxability of the issue. In lieu of the loss of tax exemption, the Treasury Secretary may impose a penalty equal to 50% of the amount that should have been rebated, plus interest thereon. This other remedy of the federal government will only apply to governmental bonds and only if the failure to pay the rebate was not due to wilful neglect. Any or all of the 50% penalty may be waived by the Treasury Secretary.

## BANK-QUALIFIED ISSUES

One of the many changes wrought by the Act is the inability of banks and other financial institutions to deduct any portion of the interest expenses that they incur for the acquisition of and carrying of tax-exempt obligations acquired after August 7, 1986.[3] The Act provides one exception to this general rule -- the exception for "qualified" tax-exempt obligations issued by small issuers. Thus, when banks and other financial institutions are bidding on bonds and notes to be issued by governmental units, they will be interested in knowing if the issue is "qualified."

To be "qualified" an issue must be:

(a) an issue of tax-exempt obligations other than "private activity bonds,"[4] but including any obligations issued on behalf of a 501(c)(3) not-for-profit entity; and

(b) designated by the issuer as "qualified" obligations; (the issuer reasonably cannot expect to issue greater than $10,000,000 of obligations described in paragraph (a) in the calendar year.)

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[3] Under previous law, 80% of interest expenses were allowed as a deduction.

[4] Generally, private activity bonds are bonds the proceeds of which will be loaned to a private party (other than a governmental unit) or will be used in the trade or business of a private party and will be secured by payments from a private party.

For purposes of determining whether an issuer meets the $10,000,000 small issuer requirement, an issuer and all "subordinate entities" must be counted together as one issuer. The Conference Report accompanying the Act defines subordinate entities to include entities deriving their issuing authority from another entity or subject to substantial control by another entity.

Until regulations further explaining the Act are promulgated by the Internal Revenue Service, any independent authorities created by a unit of government should be treated as a subordinate entity.

Thus, in New Jersey, municipalities must add the amount of debt issued and expected to be issued by all independent authorities, including regional authorities, created by them. Debt of school districts, fire districts, the county, any county authorities or the State are not included in this calculation.

Type II school districts and fire districts in New Jersey will stand alone. They have no subordinate entities and do not include the debt of the municipality, county or State.

Counties will include all debt issued by authorities which are created by the county, but will not include obligations issued by any municipality or by the State.

Until regulations are promulgated, authorities should include debt issued by the governmental unit or units which created the authority (the municipality, county or State, as

appropriate) and any other authorities created by such governmental unit or units. There is no way to prudently allocate only a portion of regional authority debt. Therefore, each governmental unit that makes up the regional authority should count 100% of the regional debt. Likewise, a regional authority should count the debt of each governmental unit that created it.

## How To Determine If An Issue May Be Qualified

1. Determine that the obligations are not private activity bonds.
2. Add the amount of bonds or notes (including any tax anticipation notes or special emergency notes) issued so far in the calendar year.
3. Estimate the additional amount of bonds or notes that will be issued in the calendar year.
4. Determine if the debt obligations which are issued by other entities must be taken into account.
5. Add the amount of bonds or notes issued so far in the calendar year for such entities.
6. Receive estimate of the additional amount of bonds or notes that such entities will issue in the calendar year.

If the sum of amounts in 2 + 3 + 5 + 6 is less than $10,000,000 and if the obligations are not private activity bonds, then the issue may be "qualified."

The designation of an issue as "qualified" is generally done by execution of a certificate to this effect at the closing.

## FORM 8038-G INFORMATIONAL RETURNS

Form 8038-G is an informational form that must be completed and filed with the Internal Revenue Service for each and every issuance of tax-exempt governmental debt in excess of $100,000, including bonds, notes, and leases that are financing leases. For issues of less than $100,000, Form 8038-GC must be filed. The requirement to file Form 8038-G applies to all debt issued on and after January 1, 1987. A copy of Form 8038-G is attached to this article.

The information that must be provided is (1) the purpose of the issue, (2) a description of the issue, including, maturity date, interest rate, "issue price," weighted average maturity, yield and net interest cost, (3) a breakdown of the use of the proceeds, (4) a description of any bonds or notes that the issue is refunding or paying off, if any, (5) whether or not the issuer expects to rebate arbitrage to the federal government, and (6) whether or not the issue is a bank-qualified issue (see discussion above).

Most of the information is readily available to the issuer or to bond counsel completing the form. However, issue price and yield are based upon the reoffering yields to the public, not the amount of the issue or the interest rate on the bonds or notes. Likewise, weighted average maturity and net interest

cost are based on issue price, not stated principal maturities or stated interest rates. The reoffering yields to the public (excluding bond houses, brokers and other intermediaries) should be certified by the purchaser of the obligations at the time of closing.

The completed forms must be filed on or before the 15th day of the second calendar month after the close of the calendar quarter in which the closing for the issue took place. The deadlines stated simply are as follows:

| Date of Issue (Closing Date) | Filing Deadline |
|---|---|
| January 1 to March 31 | May 15 |
| April 1 to June 30 | August 15 |
| July 1 to September 30 | November 15 |
| October 1 to December 31 | February 15 |

Form 8038-GC is filed on an annual basis, after the close of the calendar year. Form 8038-GC is not yet available.

The 8038-G and the 8038-GC Forms must be filed with the Internal Revenue Service Center in Philadelphia, Pennsylvania 19255. Failure to file the required form or failure to file it on time will cause the loss of tax-exemption of the issue. The Internal Revenue Service, on the basis of a written letter ruling request, will generally relieve an issuer from this drastic penalty if there is a legitimate reason for the failure to comply with these provisions.

## CONCLUSION

The Act imposes many new obligations on the all tax-exempt bond issuers. Greater attention to the planning of note sales and bond sales and more detailed accounting of proceeds therefore is required. This article outlines only three of these new provisions. Issuers should contact bond counsel early in the planning stages of financing to obtain advice regarding specific issues.

## EXHIBIT A

### Market Price Rules

1. The market price of an obligation shall be the mean of the bid and offered price on an established market where such obligation is traded on the date of a binding contract to acquire such obligation, or, if there are no bid and offered prices on such date, on the first day preceding such date for which there are bid and offered prices;

2. Any obligation for which there is not an established market shall not be purchased;

3. Any market especially established to provide an obligation to the issuer will not be treated as an established market;

4. The mean market price may be determined by reference to any appropriate publication, such as, for example, "Composite Closing Quotations for United States Government Securities" published by the Federal Reserve Bank of New York;

5. Where the price of an obligation is quoted on an established market in terms of yield, the market price shall be the price necessary to produce such yield using the method of computing yield under the Internal Revenue Code of 1986;

6. The market price of an obligation may be established by the borrowing practices of the issuer of the obligation as, for example, by determining the market price based on the interest ordinarily paid by such issuer to persons other than governmental units with respect to obligations of comparable maturities;

7. The market price of a time or demand deposit shall be determined under the preceding paragraph by taking into account the yield that would be paid by the obligor if the deposit where held as an interest bearing deposit for the expected period of the deposit, except that if the yield actually paid is higher than such yield the market price shall be the amount of the deposit;

8. The market price for a certificate of deposit issued by a commercial bank may be determined as the bona fide bid price quoted by a dealer who maintains an active secondary market in such certificates of deposit;

9. If the price paid for an obligation is lower than the mean market price, such lower price shall the market price;

10. If the price paid for an obligation is higher than the mean market price, such higher price may be used as the market price only if the obligation is acquired in an arm's length transaction without regard to any amount paid to reduce the yield of the obligation; and

11. Where a United States Treasury obligation is acquired directly from the United States Treasury, such acquisition shall be treated as establishing a market for such obligation and as establishing the market price of such obligation.

In determining the purchase price of any obligation no adjustment shall be made for any expenses of acquisition or underwriters' or brokers' discount.

For purposes of these rules, yield means that percentage rate which when used in computing the present value of all payments of principal and interest on an obligation produces an amount equal to the purchase price thereof. For purposes hereof, yield is, and shall be calculated on a 360-day year basis with interest compounded semiannually.

Note: For purposes of calculating yield on the issue of tax-exempt obligations, yield means that percentage rate which when used in computing the present value of all payments of principal and interest on an obligation produces an amount equal to the issue price (within the meaning of § 1273 and § 1274 of the Code) thereof. Payments for bond insurance premiums and letter of credit fees related to providing security for an issue may be treated as additional interest on the obligations to the extent that the savings exceeds the cost of the premiums or the letter of credit fees.

Form **8038-G**
(December 1986)
Department of the Treasury
Internal Revenue Service

# Information Return for Tax-Exempt Governmental Bond Issues

▶ Under Section 149(e)
(Use Form 8038-GC if issue price is under $100,000.)

OMB No 1545 0720
Expires 12-31-89

**Part I Reporting Authority** — Check box if **Amended Return** ▶ ☐

1 Issuer's name

2 Issuer's employer identification number

3 Number and street

4 Report number G198 ___ - ___

5 City or town, state, and ZIP code

6 Date of issue

**Part II Type of Issue (check box(es) that applies)**

| | | Issue Price |
|---|---|---|
| 7 | Check box if bonds are tax or other revenue anticipation bonds ▶ ☐ | |
| 8 | Check box if bonds are in the form of a lease or installment sale ▶ ☐ | |
| 9 | ☐ Education | |
| 10 | ☐ Health and hospital | |
| 11 | ☐ Transportation | |
| 12 | ☐ Public safety | |
| 13 | ☐ Environment (including sewage bonds) | |
| 14 | ☐ Housing | |
| 15 | ☐ Utilities | |
| 16 | ☐ Other. Describe (see instructions) ▶ _____ | |

**Part III Description of Bonds**

| | (a) Maturity date | (b) Interest rate | (c) Issue price | (d) Stated redemption price at maturity | (e) Weighted average maturity | (f) Yield | (g) Net interest cost |
|---|---|---|---|---|---|---|---|
| 17 Final maturity | | % | | | | | |
| 18 Entire issue | | | | | years | | |

**Part IV Uses of Original Proceeds of Issue (including underwriters' discount)**

| | | | |
|---|---|---|---|
| 19 | Proceeds used for accrued interest | 19 | |
| 20 | Proceeds used for bond issuance costs (including underwriters' discount) | 20 | |
| 21 | Proceeds used for credit enhancement | 21 | |
| 22 | Proceeds allocated to reasonably required reserve or replacement fund | 22 | |
| 23 | Proceeds used to refund prior issues | 23 | |
| 24 | Nonrefunding proceeds of the issue (subtract lines 20, 21, 22, and 23 from line 18, column (c)) | 24 | |

**Part V Description of Refunded Bonds (complete this part only for refunding bonds)**

25 Enter the remaining weighted average maturity of the bonds to be refunded ▶ _____ years

26 Enter the last date on which the refunded bonds will be called ▶ _____

27 Enter the date(s) the refunded bonds were issued ▶ _____

**Part VI Miscellaneous**

28 Enter the amount (if any) of the state volume cap allocated to this issue ▶ _____

29 Arbitrage rebate:

a Check box if the small governmental unit exception to the arbitrage rebate requirement applies ☐

b Check box if the 6-month temporary investment exception to the arbitrage rebate requirement is expected to apply ☐

c Check box if you expect to earn and rebate arbitrage profits to the U.S. ☐

30 Enter the amount of the bonds designated by the issuer under section 265(b)(3)(B)(ii) ▶ _____

31 Pooled financings:

a Check box if any of the proceeds of this issue are to be used to make loans to other governmental units ▶ ☐ and enter the amount ▶ _____

b Check box if this issue is a loan made from the proceeds of another tax-exempt issue ▶ ☐ and enter the name of the issuer ▶ _____ and the date of the issue ▶ _____

**Please Sign Here**

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete

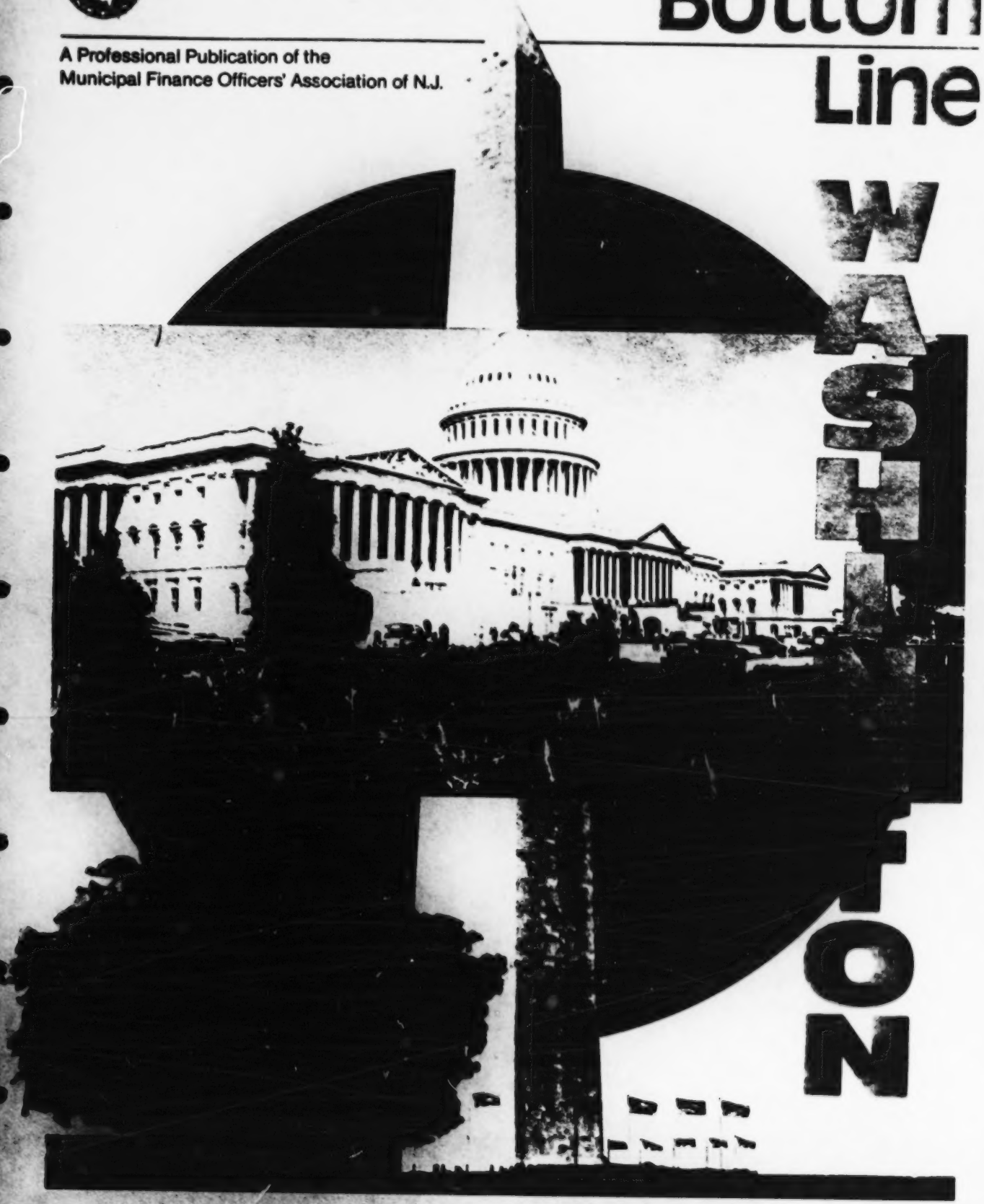
▶ _____ Signature of officer — Date ▶ _____ Title

**For Paperwork Reduction Act Notice, see page 1 of the Instructions.** Form **8038-G** (12-86)

Volume 5, Number 1 ■ Spring/Summer 1987

# the Bottom Line

A Professional Publication of the
Municipal Finance Officers' Association of N.J.




**Special Washington, D.C. Supplement Inside**

# Congress and Courts Deprive States of Sovereign Powers: The Power to Tax is the Power to Destroy

**John L. Kraft and Felicia L. Garland**

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It is ironic that as we celebrate the 200th anniversary of the signing of the United States Constitution, Congress and the federal courts have abandoned a basic constitutional principle that has shaped the relationship between the federal government and the sovereign States throughout our nation's history. That principle is called the doctrine of intergovernmental tax immunity, which simply means that the States cannot tax the federal government and *vice versa*. Apparently, the courts have forgotten that famous declaration made over 150 years ago by Chief Justice John Marshall that "the power to tax involves the power to destroy." This disturbing trend is nowhere more apparent than in four recent cases dealing with recent federal enactments. Three cases involve a new Social Security law which indirectly imposes federal income taxes on otherwise tax exempt municipal bond interest. They are *Boli v. United States, Shapiro v.*

Courtesy of *The Newark Star Ledger*

*Baker* and *Goldin v. Baker*. The fourth case, *South Carolina v. Baker*, challenges a federal law that denies tax exempt status to municipal bonds if issued in bearer form rather than registered form.

## Recent Cases Destroy Tax Exemption

Each plaintiff in *Boli*, *Shapiro*, and *Goldin* challenged Section 86 of the Internal Revenue Code. Section 86 requires Social Security recipients to pay federal income taxes on their benefits if they have too much other income. This "other income" includes interest earned on tax exempt municipal bonds. The result is that senior citizens must pay federal taxes because they earn interest on municipal bonds. With the adoption of Section 86, Congress has moved one step closer to abolishing the tax exemption for interest earned on municipal bonds.

In 1984, Louis G. and Mary K. Boli, two retired Social Security recipients from California, paid $548 in tax to the United States Treasury pursuant to Section 86. This payment was purely the result of the interest earned by the Bolis on their municipal bonds. Were it not for the inclusion of tax exempt interest they received from municipal bonds, the Bolis would not have had any tax liability.

The Bolis sued to recover their $548, arguing that the tax was due solely to the inclusion of municipal bond interest as required by Section 86. Thus, Section 86 was a tax on municipal bonds and therefore prohibited by the tax immunity doctrine. The United States argued that Section 86 was intended only to tax Social Security benefits and was not a tax on municipal bonds. The judge could not make up his mind whether the tax imposed by Section 86 was indeed a tax on municipal bonds or purely a tax on Social Security benefits. Rather, he chose to focus on the extent of the intergovernmental tax immunity doctrine. He concluded that the doctrine had been severely limited in recent years and was not an absolute ban on the ability of the federal government to tax the States. According to the judge, the question today is whether the federal "tax impair(s) the state's ability to function." He held that Section 86 did not violate his version of the doctrine.

The intergovernmental tax immunity doctrine was weakened further in the other two recent cases challenging Section 86—*Shapiro* and *Goldin*. Both cases were brought by issuers of tax exempt municipal bonds.

In *Goldin*, the Comptroller of the City of New York argued that the Section 86 tax threatens the City's ability to provide essential services by impairing the City's ability to borrow money. The appeals court upheld a lower court's opinion that Section 86 is a tax on Social Security income only and not a tax on municipal bonds. The appeals court admitted that Social Security recipients might have to pay federal taxes on their benefits purely as a result of interest they earn on municipal bonds, but that alone did not make Section 86 a direct tax on municipal bond interest. The judge in *Goldin* determined that the intergovernmental tax immunity doctrine did not apply because Section 86 imposed only an indirect burden on the ability of the city to function.

In *Shapiro*, the County Executive of Essex County, New Jersey challenged Section 86, arguing that the county's ability to raise revenue—a fundamental function of government—was hampered by Section 86 in violation of the Constitutional doctrine of intergovernmental tax immunity. The court employed yet another line of reasoning to uphold the constitutionality of Section 86. It determined that the intergovernmental tax immunity doctrine applies only where the governmental entity itself is legally obligated to pay the tax. The doctrine was not applicable in this case since Section 86 was not a tax placed directly upon the States.

*Boli* and *Goldin* imply that the doctrine is no longer an absolute prohibition to federal taxation of interest on municipal bonds. Instead, the courts appear to measure the burden on the States' ability to borrow. They hint that at some point the burden might become too great and the doctrine would be violated. However, how do the courts determine when Congress has gone too far? When do the additional costs, such as higher interest costs incurred by issuers as a result of a tax, become so high so as to destroy the States' ability to borrow? The court in *Shapiro* looked for a "direct tax." But doesn't the higher interest it must pay to issue taxable obligations constitute a direct burden on the States?

Equally distressing as the Social Security cases is *South Carolina v. Baker*, a case currently before the United States Supreme Court. South Carolina challenged the constitutionality of a requirement imposed by the Tax Equity and Fiscal Responsibility Act (TEFRA) that municipal bonds be issued in registered form or face the loss of tax exemption. Although bearer bonds were preferred by the overwhelming majority of State and local issuers, the threatened loss of tax exemption means that they no longer issue bearer bonds.

South Carolina challenged the new law for two reasons: (1) As a regulatory measure, the registration requirement violates the principles of Federalism expressed in the United States Constitution; and (2) The denial of tax exemption for municipal bonds for failure to comply with the registration requirement violates the doctrine of intergovernmental tax immunity. When first filed, few States or associations representing local governments supported South Carolina in its efforts. Some believed that registered bonds would be an improvement over bearer bonds. This attitude ignores the challenge to the basic power of the States to issue tax exempt bonds. However, some 25 States since have joined with South Carolina in this suit.

The Court-appointed special master in the case recently released his factual findings and issued a report which bodes ill for the States. The special master found that the registration requirement does not significantly affect the States' ability to raise money. He concluded that the registration requirement of TEFRA is a permissible exercise of federal regulatory power over the States. He also concluded that the use of the tax sanction for failure to comply with the registration requirement does not violate the intergovernmental tax immunity

doctrine. The special master sidestepped the issue as to whether a tax on municipal bond interest would be constitutional. The Supreme Court has yet to issue an opinion in the case. If the trends exhibited in these recent cases continue, the outlook for the States is bleak.

## Federalism and the Tax Immunity Doctrine

Freedom from federal taxation of municipal bonds has its roots in the doctrine of Federalism incorporated in the United States Constitution. As expressed in the Tenth Amendment to the Constitution, Federalism means that the authority of the national government extends only to specifically enumerated powers. All powers not delegated by the States to the national government, nor denied to the States by the Constitution, are reserved to the States. James Madison described Federalism in *Federalist No. 45* by stating that:

> "The powers delegated by the proposed Constitution to the Federal Government are few and defined. Those which are to remain in the State Government are numerous and indefinite. The former will be exercised principally on external objects, as war, peace negotiation, and foreign commerce; . . . The powers reserved to the several States will extend to all the objects which, in the ordinary course of affairs, concern the lives, liberties, and properties of the people, and the internal order, improvement, and prosperity of the States."

Intergovernmental tax immunity, as part of the doctrine of Federalism, was proclaimed by the courts in one of the Supreme Court's early landmark opinions—*M'Cullough v. Maryland* (1819). The State of Maryland had adopted legislation, the effect of which was to tax the operations of a branch of a federally chartered bank. In his arguments on behalf of the federal interest, Daniel Webster asked the Court a question which is as important today as it was then. "If this power of taxation be admitted, what is to be its limits?" Chief Justice Marshall rendered the Court's decision to invalidate the Maryland law, recognizing that the power to tax is the power to destroy.

Courtesy of *The Newark Star Ledger*

About 100 years later, the federal government enacted a tax on municipal bond interest. The Supreme Court declared this federal tax on State operations just as unconstitutional as Maryland's attempt to tax the federal government's activities. In *Pollock v. Farmer's Home Loan and Trust Co.* (1895), the Supreme Court held that it was unconstitutional for the federal government to tax interest earned on municipal bonds. The Court declared that:

> ". . . under the fundamental law, as to the power to borrow money, neither the United States on the one hand, nor the States on the other, can interfere with that power as possessed by each and an essential element of the sovereignty of each."

Further, the Court said that a federal tax on municipal bonds "is a tax on the power of the States and their instrumentalities to borrow money and consequently, repugnant to the Constitution." Thus, in *Pollock* the Supreme Court made it clear that a State's power to borrow money is a sovereign power free from federal limitation or taxation.

## The Federal Government Taxes the States

Despite the strong words in *Pollock*, the federal government has abandoned the doctrine of Federalism that protected it against the sovereign States during its fledgling period. Now the full grown American eagle is destroying the sovereignty of the States through taxation. At first, the actions were modest and not challenged by the States. In 1968, limits were placed on State public purposes by the industrial development bond provisions. The next year, the Internal Revenue Code was amended to restrict the States' ability to invest bond proceeds. No State challenged these laws. TEFRA came in 1982 and South Carolina sued over the registration issue. Only three plaintiffs attacked the Social Security provisions enacted in 1983. None of the other restrictions on tax exempt bond financing was attacked. The Deficit Reduction Act of 1984 brought further restrictions, including a dollar limitation on each State for certain kinds of tax exempt bonds. Still no challenge, except for *South Carolina, Boli, Golden* and *Shapiro*. Emboldened by this successful attack on

State sovereignty, Congress and the Treasury Department conspired to impose on the States severe new tax restrictions in the Tax Reform Act of 1986.

Basically, the Tax Reform Act of 1986 violates State sovereignty, Federalism and the doctrine of intergovernmental tax immunity in the following ways:

1. Under certain circumstances, federal income taxes are imposed on interest on municipal bonds.
2. The federal government, not the States, decides when, under what circumstances and for what purposes States may issue tax exempt bonds.
3. A federal income tax, in the guise of a "rebate" requirement, is imposed directly on the operations of the States. Rebate means the States must send all investment income from the temporary investment of bond proceeds to the federal government.

The attack on tax exempt interest is far from over. Subsequent to the Tax Reform Act of 1986, a new Superfund Tax was imposed on certain corporations. The tax is imposed on corporate income, including interest income from municipal bonds. It is likely that any future taxes of a similar nature also will tax tax-free bonds.

## The States Fight Back

Having little or no success in the Congress or the courts, States and local government issuers are now proceeding on another front. Recently, the Utah Legislature approved a resolution calling for a Constitutional convention to amend the Sixteenth Amendment (which authorizes the federal income tax) to restore the original intent of our Founding Fathers to maintain the sovereignty of the States. The resolution has also been introduced in the Kansas, Georgia and South Carolina legislatures. The Sixteenth Amendment would be changed to include the following language:

> "So that the right of the States to finance the public purposes established by them or their electors shall not be infringed, the Congress shall lay no direct or indirect tax upon the income derived from general or special obligations issued by or on behalf of the States, their political subdivisions or authorized authorities, nor upon the proceeds thereof or income on such proceeds, nor from governmental activities, nor shall it otherwise tax or restrict such obligations or exclude, as deductions from income, taxes paid pursuant to the laws of any State or interest on amounts borrowed by any financial institution to purchase or carry such obligations."

This effort to restore and protect the States' right to issue tax exempt bonds is picking up momentum. However, before a convention can be convened, the resolution must be approved by 34 States. Thirty-eight States would have to approve the change before it could become part of the Constitution.

Courtesy of *The Newark Star Ledger*

## A Call To Action

Those States which agree that Congress and the courts have overstepped their authority need to proceed quickly. On February 20, 1987, *The Daily Bond Buyer* reported that the chief tax economist for the House Ways and Means Committee suggested that Congress might seek to extend the alternative minimum tax to interest earned from all tax exempt bonds. The last time such an idea was proposed, the municipal bond market came to a complete standstill. That was just over one year ago on March 19, 1986, when then-Chairman of the Senate Finance Committee Bob Packwood introduced his proposal to extend the minimum tax to all "tax exempt bonds."

The States and all issuers of municipal bonds must act quickly and in union to reestablish their sovereign powers and to preserve their ability to issue tax exempt bonds. That action can take many forms. For instance, carefully managed lawsuits against the federal government should challenge specific provisions of the Tax Reform Act of 1986. Lobbyists on behalf of the States and local issuers should alert their Congressional representatives about the increased costs and additional obstacles imposed by the Tax Reform Act of 1986 and Section 86. As mentioned above, State legislatures should consider and adopt the resolution calling for the Constitutional amendment.

*(continued on page 45)*

## Congress and Courts Deprive States of Sovereign Powers: The Power to Tax is the Power to Destroy

*(continued from page 10)*

And lastly, the States should remember the old adage "turnabout is fair play." If the federal government can tax State and local bonds, the States should tax interest earned on federal securities that currently remains exempt from state taxation. Such an effort will demonstrate the need to maintain the governmental tax immunity doctrine envisioned by our Founding Fathers and embodied in *M'Cullough v. Maryland* and the *Pollock* case.

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**TESTIMONY OF**
**JOHN L. KRAFT, ESQ.**
**KRAFT & HUGHES, NEWARK, NEW JERSEY**
**ON THE**
**TAX REFORM ACT OF 1986**
**BEFORE THE**
**ASSEMBLY ECONOMIC DEVELOPMENT**
**AND AGRICULTURE COMMITTEE**
**AND**
**THE ASSEMBLY APPROPRIATIONS SUBCOMMITTEE**
**ON GOVERNMENT OPERATIONS**

**OCTOBER 20, 1986**

## INTRODUCTION

Federal legislation restricting the use of tax exempt bond financing by state and local governments dates back to 1968 when the Internal Revenue Code was amended to define industrial development bonds and to limit the circumstances under which tax exempt industrial development bonds might be issued by states and political subdivisions to accomplish their public purposes. In the following year, the Internal Revenue

Code was amended again, this time to define "arbitrage bonds" and to deny tax exempt status to bonds which do not comply with complex and technical rules regarding the investment of proceeds of tax exempt bond issues.

In 1982 the Tax Equity and Fiscal Responsibility Act imposed additional restrictions on the use of industrial development bonds and also provided that all municipal bonds must be issued in registered form. Failure to do so results in loss of their tax exempt status. This provision is the subject of a Constitutional challenge now pending before the Supreme Court of the United States. In 1984 the Deficit Reduction Act added additional restrictions on the use of industrial development bonds and, for the first time, imposed a state-by-state limitation on the amount of industrial development bonds that might be issued. This State Volume Cap for New Jersey amounted to a limitation of approximately $1.1 billion.

The ink was hardly dry on DEFRA when the Treasury Department announced a tax reform program that would make sweeping changes in the Internal Revenue Code. The use of tax exempt bonds by state and local governments was singled out for particularly harsh treatment. This plan was called Treasury 1 and was superseded by Treasury 2 in the Spring of 1985. Treasury 2 was President Reagan's formal proposal for tax reform. It contained severe restrictions on the ability of

state and local governments to issue tax exempt bonds. By some estimates, up to two-thirds of tax exempt volume would be prohibited by the federal government.

The debate on tax reform was waged in Congress in the Fall of 1985. On December 17, 1985 H.R. 3838 was passed by the House of Representatives. While not as draconian as Treasury 1 and Treasury 2 in the area of tax exempt bonds, H.R. 3838 significantly infringed upon the prerogatives of state and local governments to carry out public purposes by the use of tax exempt bonds.

In 1986 the debate shifted to the Senate and, on June 24, 1986, the Senate adopted its version of tax reform. The Senate version modified and reduced the negative impact of H.R. 3838 on the tax exempt sector. Issuers breathed a collective sigh of relief even though the Senate version contained curbs on the use of tax exempt bonds to carry out state public policies. During August a House-Senate Conference Committee was established to reach agreement on a tax reform bill which could be adopted by Congress. The results of the Conference Committee were released in outline form at the end of August. Late in September Congress passed the final legislation and on October 22, 1986 President Reagan signed into law the Tax Reform Act of 1986. Most of the "relief" provided in the Senate Bill was rejected by the Conference Committee in order to raise additional revenues to keep the tax rates low. This

means that state and local governments will have to pay higher costs to undertake their public projects in order to subsidize the reduction of federal tax rates. Of course, the only way these additional monies will be raised is through higher taxes by state and local governments to carry out their capital improvement programs.

## SUMMARY OF PROVISIONS OF TAX REFORM ACT AFFECTING STATE AND LOCAL GOVERNMENT

1. Definition of Tax Exempt Bonds. Each bond issue must be subjected to a test to determine its tax exempt status. Bonds will be tax exempt only if 10 percent or less of the proceeds will be used in private businesses and 10 percent or less of the principal or interest will be provided by payments from private businesses. Bonds which fail this test are now called Private Activity Bonds. This definition is much stricter than the existing 25 percent threshhold for industrial development bonds. Other aspects of the test could cause the bonds to be taxable Private Activity Bonds even if less than 10 percent of the proceeds benefit a private person. An entire public purpose bond issue may be taxable because of a privately operated support service in a public building. For example, if the food service area occupies more than 10 percent of a public facility and a private operator enters into a long-term

contract to provide food services at the facility and agrees to pay rent for the use of the facility, this would cause the bonds to be Private Activity Bonds. The entire issue would be denied tax exemption. On the other hand, if a facility such as a sewer system offers its services to members of the general public on the same basis, the bond will not be a Private Activity Bond even though more than 10 percent of the sewer system serves a particular private business.

2. Types of Private Activity Bonds That May Be Tax Exempt. Tax exempt Private Activity Bonds are permitted for housing; governmentally owned airports, docks and wharves; mass commuting facilities; water, sewer and solid waste facilities; local electric, gas and heating and cooling facilities; hazardous waste disposal facilities; certain urban renewal projects; and small issue Private Activity Bonds. After December 31, 1986 only manufacturing facilities qualify for tax exempt small issue Private Activity Bonds. After December 31, 1989 even manufacturing facilities will be prohibited, thus eliminating entirely the exempt small issue category. Private Activity Bonds will no longer be allowed for sports, convention, trade show, parking or pollution control facilities or for industrial parks.

3. Housing Bonds. Home mortgage revenue bonds currently slated to be phased out as of December 31, 1987 are given another year to December 31, 1988. Multi-family housing

bonds remain tax exempt. All housing bonds are subject to the new State Volume Cap limitations.

4. 501(c)(3) Organizations. Non-profit colleges, hospitals and other 501(c)(3) organizations may use the proceeds of tax exempt bonds without being subject to the State Volume Cap. However, except for hospitals, not more than $150 million may be outstanding at any time for any one institution.

5. State Volume Cap Limitations. A new State Volume Cap becomes effective August 15, 1986 and applies to student loan bonds, housing bonds and most Private Activity Bonds. Private Activity Bonds for airports, docks and wharves (which must be governmentally owned to qualify for tax exempt financing) and governmentally owned solid waste facilities, as well as 501(c)(3) bonds are not subject to the State Volume Cap. The State Volume Cap initially is $75 per capita and after December 31, 1987, the volume cap drops to $50 per capita. For New Jersey this means a limitation on Private Activity Bonds subject to the cap of $564 million in 1987 and $366 million in 1988 and thereafter. This compares with the approximately $1.1 billion of industrial development bonds that have been issued annually in the State of New Jersey.

6. Limits on Advance Refundings. Advance refundings are prohibited for Private Activity Bonds, student loan bonds and mortgage revenue bonds. Advance refundings for governmental bonds, and bonds for non-profit organizations

would be limited as follows: bonds originally issued before January 1, 1986 could not be refunded more than two times. However, if such bonds were advance refunded two or more times before March 14, 1986, one additional advance refunding would be permitted. For bonds originally issued after December 31, 1985, no more than one advance refunding is permitted.

7. Arbitrage and Rebate. Existing arbitrage restrictions are carried forward and made even more onerous under the new tax law. All profits from the investment of bond proceeds must be rebated to the federal government unless all of the bond proceeds are spent within six months. This provision will not apply to governmental issuers who do not issue more than $5 million of debt annually. In calculating the amount of profit, issuers will be allowed to take into account bond insurance and letter of credit fees. However, no other underwriting costs, costs of issuance or costs of managing investments will be taken into account in determining the amount of profit earned from the investment of bond proceeds. The rebate requirements amount to an income tax on the investment activities of state and local governments in excess of 100%.

8. Reporting of Bond Issues. A report to the Internal Revenue Service of each issue of obligations (bonds and notes) will be required.

9. Minimum Tax. Interest on newly issued Private Activity Bonds, student loan bonds and home mortgage revenue bonds would be a tax preference item subject to the alternative minimum income tax on individuals. All tax exempt interest would be included in calculating the book income of corporations, half of which is subject to the alternative minimum tax.

10. Bank Interest. At the present time 80 percent of the interest paid by banks as an expense in the acquisition of tax exempt bonds is deductible as a business expense. The Tax Reform Act eliminates this deduction for banks with respect to tax exempt bonds acquired after August 7, 1986. This denial of deduction does not apply for bonds issued by governmental issuers or non-profit organizations which expect to issue less than $10 million of debt per year and which designate and qualify their bonds for this special treatment.

11. Property and Casualty Insurers. Underwriting losses of property and casualty insurers, normally deductible, are reduced by an amount equal to 15 percent of the tax exempt interest received on bonds acquired after August 7, 1986.

## THE TAX REFORM ACT IS UNCONSTITUTIONAL

Does the federal government have the constitutional power to tax interest on state and municipal bonds? If so, all

the provisions described above are lawful and tax exempt bonds could be eliminated totally. However, the right of states and local governments to issue tax exempt bonds finds its roots in our Constitution and is basic to the freedom of all Americans.

A brief historical review of municipal bond tax exemption within the context of our federal form of government is helpful in placing the proposed tax reforms in proper perspective. Federalism is the basic principle of American government. The sovereign states granted certain limited powers and purposes to the federal government, as provided in the Constitution. All other powers are reserved to the states respectively, or to the people.

In order to preserve the balance between federal and state powers, the doctrine of reciprocal immunity evolved over the years. Reciprocal immunity means that the federal government may not infringe on state prerogatives and vice versa. In an early landmark case -- McCullough v. Maryland (1819) -- the Supreme Court held that a state may not tax federally chartered banks. In 1895, the Supreme Court held that it is unconstitutional for the federal government to tax interest on state and municipal bonds. In that case, Pollock v. Farmers' Home Loan and Trust Co., the Court said such taxation was a "burden on the operations of government. It may be carried on to an extent which may arrest them completely." Thus, in these early cases, the doctrine of reciprocal immunity was spelled out.

In the years since 1895, and as recently as 1985, the Supreme Court has modified and minimized the doctrine of reciprocal immunity. In Garcia v. San Antonio Metropolitan Transit Authority (SAMTA) (1985) the Supreme Court held that a government owned and operated mass transit system must comply with the federal minimum wage and overtime requirements of the Fair Labor Standards Act. SAMTA claimed it was immune from federal regulation because it was performing a "traditional governmental function." In earlier cases, particularly National League of Cities v. Usery (1976), the Supreme Court had recognized that, when engaged in traditional governmental functions, states are immune from federal interference. The Garcia decision rejects this analysis and states that the Supreme Court will no longer make determinations of what is or is not a valid state policy. In Garcia, the Supreme Court indicated what the states must do to prevent intrusion by the federal government into traditional state functions. The states must lobby, consult and cajole Congress to prevent any legislation that would eliminate or restrict tax exemption for municipal bonds.

If this fails, the states must be ready to petition the Supreme Court for relief despite the holding in Garcia. The history of tax exemption under federal statutory law demonstrates an increasing antagonism by the U.S. Department of the Treasury and certain members of Congress towards tax

exemption. In 1913 after adoption of the Sixteenth Amendment to the U.S. Constitution, the federal government imposed the first general federal income tax. The initial statute provided tax exemption for interest on state and municipal bonds. Almost from the beginning, Treasury officials indicated opposition to tax exemption. In the 1920s, Treasury Secretary Andrew Mellon complained that tax exemption gave states a competitive borrowing edge over the federal government and also deprived the federal treasury of needed revenues. This philosophy, which rejects the constitutional basis for tax exemption, has been espoused by Treasury officials over the years. In recent years, some members of Congress have become convinced that tax exemption should be restricted and ultimately eliminated.

In 1936, the state of Mississippi embarked on a program called "Balance Agriculture With Industry." For the first time, a state declared it to be in the public interest to finance factories with tax exempt bonds. The public purpose of this plan was to encourage industries to locate in Mississippi and thus create industrial jobs for its citizens. At that time there was no response from the federal government and no indication that the federal government questioned the validity of the public purpose or the right of Mississippi to implement this program.

Perhaps the earliest Treasury formal attack on the use of tax exempt bonds came in the 1940s when the Internal Revenue Service attempted to tax interest on bonds issued by the Port Authority of New York and New Jersey. The IRS's theory was that the Port Authority was not a political subdivision. Therefore, it was not entitled to issue tax exempt bonds for its projects, which included such public facilities as the Holland Tunnel, the Lincoln Tunnel and the George Washington Bridge. The IRS was unsuccessful and abandoned its efforts when the U.S. Second Circuit Court of Appeals in 1944, held that the Port Authority was indeed a political subdivision performing traditional governmental functions.

Between 1936 and the 1960s, the use of tax-exempt bonds for construction of privately operated facilities spread to other states. These bonds came to be known as industrial development bonds ("IDBs"), and their use greatly increased. In 1968 Congress enacted legislation which for the first time denied to the states the power to issue tax exempt bonds. The 1968 amendment provides that unless IDBs meet federal guidelines, tax exempt status is denied. This was the first time that the federal government said that it, rather than the states, would determine the validity of state public purposes and would deny tax exemption for those purposes deemed unworthy by the federal government. No state or local government challenged the validity and constitutionality of the 1968 IDB legislation.

Having achieved success in limiting tax exemption in 1968, Congress acted again in 1969 to deny tax exemption to "arbitrage bonds." Arbitrage bonds are obligations issued at a low tax exempt rate by a state or political subdivision, which then invests the proceeds for some period of time in higher yielding taxable obligations. It is a traditional and prudent fiscal practice by governmental units to borrow money at the beginning of a project and then pay the funds out over a period of time as the project progresses. In the meantime, the borrowed funds are invested. Congress said that if the investment of these bond proceeds did not meet federal standards, the bonds would lose their tax exempt status. This new limitation on the power of states to issue tax exempt bonds was not protested or challenged in court by any state or political subdivision.

Throughout the years, the concept of public purpose has continued to expand. Beginning in 1976, there was an explosion in the use of single-family mortgage revenue bonds throughout the nation. Many billions of dollars in tax exempt bonds were issued to create pools of funds that could be tapped by single-family homeowners for mortgage loans. The great increase in IDBs, single-family mortgage revenue bonds, health care bonds and bonds issued for other public purposes again attracted the attention of the Treasury Department and members of Congress.

In 1982 Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA). TEFRA imposed a number of new restrictions on IDBs, including a requirement to report all IDB issues to the federal government and a "sunset" provision eliminating most IDB financing after 1986. In addition, TEFRA denied tax exemption to all state and municipal bonds unless the bonds are issued in registered form, as opposed to coupon bearer form.

In 1983 South Carolina became the first state to challenge any federal legislation denying tax exempt for state and municipal bonds. South Carolina challenged the constitutionality of the registration provisions by asserting that the federal government has no power to impose an income tax on state and municipal bond interest. Some 25 other states joined with South Carolina in this suit (South Carolina v. Donald T. Regan, Secretary of the Treasury) which was filed directly in the U.S. Supreme Court. Initially, a number of states and associations representing municipal governments failed to support South Carolina. Some believed registered bonds would be an improvement over the coupon bonds. This attitude ignores the challenge to the basic right of states to issue tax-exempt bonds. Most state and local government organizations now recognize the basic issue and support South Carolina in its efforts to re-establish the constitutional basis for tax exemption. Unfortunately, the Supreme Court's

decision in the Garcia case casts some doubt on the outcome of the South Carolina case in the Supreme Court.

Federal pressure on the states' right to issue tax exempt bonds was increased in 1984 with the adoption of the Deficit Reduction Act (DEFRA). DEFRA imposed many new restrictions on IDBs, including a state-by-state volume cap, limiting the amount of tax exempt IDBs that might be issued in any year, and the elimination of arbitrage investment of bond proceeds. The restrictions are quite technical and have the impact of reducing the ability of the states to use tax exempt bonds in accomplishing their public purpose programs.

In December 1984, then Secretary of the Treasury Donald Regan released a proposed tax reform and simplification plan for comment. This plan was adopted with some minor changes by President Reagan. The president announced the administration's tax reform plan to the nation in a television speech on May 28, 1985. The Tax Reform Act of 1986 was enacted on October 22, 1986.

The provisions of this law restricting the use of tax exempt bonds and imposing federal income taxation on municipal bonds are based on the premise that the tax exemption exists as a matter of comity between the federal government and state and local governments. Tax exemption is treated as a privilege granted by the federal government and one which no longer is an effective federal subsidy program. This philosophy denies the

sovereignty of the states provided by the Constitution and also raises the spectre that state governments might tax interest income earned by their citizens on federal government obligations, which is now exempt from taxation by the states.

Lobbying efforts on behalf of state and local governments to preserve tax exemption fell on deaf -- and even hostile -- ears in Washington. Now only a court challenge or a Constitutional amendment can restore the balance between the states and the federal government envisioned by our founding fathers.

What President Reagan has referred to as a "second American revolution" can turn into an "American Tragedy" by destroying the balance that is essential to the freedoms we have enjoyed for more than 200 years.